Masaaki Shirakawa: Recent economic and financial developments and the conduct of monetary policy

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, to commemorate the 100th anniversary of the Kanazawa Branch, Kanazawa, 25 May 2009.

*   *   *

Introduction

I am honored to have the opportunity to speak before business leaders in the Hokuriku area today. I would like to express my deep gratitude for your close cooperation with the Kanazawa Branch of the Bank of Japan.

In response to strong requests from three prefectures in the Hokuriku area, the Kanazawa Branch was established in 1909 as the Bank's first branch in the districts of Honshu Island along the Japan Sea. Since then, the Kanazawa Branch has been operating in tandem with the development of the Hokuriku economy, and this year the branch celebrates its 100th anniversary. The Bank has 32 branches, including the Kanazawa Branch, and 12 local offices in Japan. Each of them conducts a variety of central banking operations, such as smooth provision of banknotes and coins, settlement of funds, treasury funds services, and research and analysis of financial institutions' business conditions and of economic and financial developments in the region. Although these operations sound unspectacular, they constitute a part of the important infrastructure that supports financial and economic activity in each region. In fiscal 2008, the sum of receipts and payments of banknotes at the Kanazawa Branch was around 2 trillion yen – 200 million notes of 10,000 yen bill. During the last 100 years, the Kanazawa Branch has strived to maintain an uninterrupted supply of banknotes in spite of occasional difficulties such as heavy snow and major earthquakes. We have renewed our determination to continue to fulfill our role of providing firm support for financial and economic activity in each region. I would like to express my gratitude again for your support and would like to ask for your continued cooperation with the Kanazawa Branch.

Before we exchange views, I would like to speak about the current situation of and outlook for the Japanese and overseas economies and also about the Bank's thinking regarding its conduct of monetary policy. I will mainly talk about economic and financial developments in Japan and abroad from a macroeconomic viewpoint, but we do fully understand that the situation varies significantly for different regions and industries, and also for different sizes of firm. In fact, the Bank gathers microeconomic information about industries and firms in each region from each branch, based on which the Bank assesses economic and price developments from a macroeconomic viewpoint and conducts monetary policy.

I. Developments in the world economy

I will start with the current situation of the world economy. The pace of deterioration in economic conditions around the world gradually accelerated from the beginning of 2008 and they have deteriorated simultaneously and sharply especially since the failure of Lehman Brothers in September. The sharp downturn in the world economy was overwhelming, considerably exceeding the projections made by international institutions, governments and central banks around the world, and private research firms. For example, the International Monetary Fund (IMF) projection of world growth for 2009 was 3.9 percent in July 2008, a rather high figure in retrospect. However, it was significantly revised downward to 0.5 percent in January 2009, and further revised downward to minus 1.3 percent in April – a significant downward revision of more than 5 percentage points in ten months.

Although many reasons are provided for the downturn in the world economy since last year, I think that the following three factors are of great importance.

First is the global accumulation of excesses and their subsequent adjustments. During the mid-2000s, financial and economic activity overheated against the background of the continued benign environment of high growth, low inflation, and low interest rates, leading to an accumulation of various excesses. For example, in the area of financial activity, risk evaluation by investors and financial institutions became lax, leading to a global credit bubble symbolized by the subprime mortgage problem. In a credit bubble, an increase in credit and leverage, and overheating in economic activity are two sides of a same coin. Examples are a substantial increase in housing investment in the United States and Europe and an expansion in demand for durable goods, such as automobiles, around the world including emerging and commodity-exporting economies. On the corporate side, production capacity was augmented by an expansion in business fixed investment to match a substantial increase in demand or by an assumption held by more than a few firms that a strong increase in demand will continue. However, looking back, such high growth supported by the credit bubble could not continue for long. When financial institutions, firms, and households start the process of adjusting excesses in economic activity, spending activity such as private consumption, housing investment, and business fixed investment will be reduced substantially. Thus, the most basic reason for the current global economic downturn exceeding many forecasts can be attributed to an unprecedented size of and the global spreading of the accumulated excesses both in financial and economic activity.

Second is an extreme decline in the functioning of financial systems worldwide since the emergence of the financial crisis triggered by the failure of Lehman Brothers last September. Due to the failure of Lehman Brothers, provider of funds, such as financial institutions and institutional investors, became extremely cautious to take counterparties' credit risks. This led to a sharp decline in the volume of transactions, not only in the interbank market where financial institutions exchange funds, but also in markets for housing loans and other securitized products, and in the CP and corporate bond markets where firms raise funds, leading to a situation of a de facto dysfunction of financial markets. In addition, banks, faced with withdrawal of deposits and concerns over their financial positions in addition to the impairment of their capital bases, suddenly tightened their lending attitudes. If the functioning of the financial system declines substantially, in terms of its function to intermediate funds in the financial markets and of extending credit by financial institutions, it is inevitable that economic activity will be adversely affected. Furthermore, the deterioration in economic activity further worsened the business conditions of financial institutions by turning housing and corporate loans into impaired assets, and this in turn further aggravated economic activity – an emergence of a negative chain reaction. This is the mechanism of the so-called adverse feedback loop between financial and economic activity, which has been used to describe the deterioration in global economic conditions from last autumn.

Moreover, a chain reaction of the financial crisis spread across the border to various countries and regions. The spreading of the U.S. and Western European financial crises to emerging and commodity-exporting economies, such as Central and Eastern Europe and Latin America, was a background factor which further increased the severity of the global economic downturn. Financial institutions in emerging and commodity-exporting economies had not invested much in securitized products backed by subprime mortgages, which became the direct cause of the current financial crisis, and, in this sense, the amount of losses they incurred was limited. Therefore, at the beginning of the financial crisis, there were views that the effects of the crisis on emerging and commodity-exporting economies would be limited. However, U.S. and Western European financial institutions and investors had been also assuming an important role in intermediating funds to these economies. Therefore, the rapid decrease in loans extended to emerging and commodity-exporting economies by U.S. and Western European financial institutions led to a significant credit contraction and a sharp deterioration in economic conditions also in these economies. Thus, the financial crisis that started in the United States and Europe spread to financial markets around the globe including those in emerging and commodity-exporting economies, and expanded the adverse feedback loop between financial and economic activity globally.

Third is substantial adjustments in production and inventories on a global scale. From last autumn, firms were suddenly faced with a large build-up of inventories due to a sharp decline in global demand. Under these circumstances, the only way to reduce inventories was to substantially reduce production. Such reduction was most prominent in the area of durable consumer goods and capital goods.

I have talked about three major factors that led to the current global economic downturn. But the direct causes of the rapid downturn since last autumn were the second and third factors, namely, the impact of the global credit contraction triggered by the failure of Lehman Brothers and large adjustments in production and inventories. Most recently, with the effects of these factors abating gradually, some signs of a slowdown in the pace of deterioration of the world economy or a leveling out are being observed.

With regard to financial conditions, money markets are beginning to regain stability on the whole due in part to the various measures taken by central banks such as provision of abundant liquidity. Confidence in the soundness of financial systems seems to be turning toward improvement after the announcement by the U.S. authorities of measures to stabilize the U.S. financial system. To restore stability in countries' financial systems, disposing of financial institutions' impaired assets and enhancement of their capital bases are necessary. In the United States, examination of the adequacy of financial institutions' capital bases was conducted by using the so-called stress test to test whether the current level of capital bases was sufficient to withstand an increase in losses in the case of a deep recession. Based on the results of the stress test, U.S. financial institutions are currently working on strengthening their capital bases. Developments in the stock market since the release of the stress test results seem to indicate that these measures to stabilize the financial system are generally welcomed.

In addition, data and anecdotal evidence show that there has been appreciable progress in the area of global-scale adjustments in production and inventories. For example, it is confirmed that inventory adjustments of automobiles and electronic parts have made progress in China and in emerging economies, such as South Korea, as well as in the United States and Europe. It is expected that this will have positive effects on production, and in fact some evidence of these effects is already observed in Japan and China.

Will the world economy level out and start to recover? If so, how sustainable will the recovery be? Based on the factors that have contributed to the downturn of the world economy, which I mentioned earlier, the keys in projecting the future path are how adjustments of accumulated excesses proceed and when the adverse feedback loop between financial and economic activity stops operating. Adjustments are currently being made gradually in the housing market in the United States and Europe, and the saving rate of households in the United States has recently started rising, indicating that there is progress toward reducing excesses in consumption and debt. Needless to say, the amount of excesses cannot be grasped accurately in advance. However, given that high economic growth continued in many years prior to the current crisis, the possibility that adjustments of excesses will take considerable time cannot be ruled out. In addition, reduction of excesses in economic activity and resolving impaired assets in financial institutions are two sides of a same coin. Although there has also been some progress made in the latter, as I mentioned earlier, it seems that more time and efforts are necessary to see progress in the restructuring of the financial system to the extent that one can conclude that the risk of adverse feedback loop between financial and economic activity has receded. Of course, there is an economic cycle, experiencing both an economic recovery and a downturn, even in the middle of the process of adjusting excesses. In fact, economic recoveries were observed in the 1990s in Japan. Nevertheless, only mild economic recoveries were realized until the adjustments of excesses were completed. In order for the economy to start a full-fledged and autonomous recovery, completion of adjustments of excesses and a firm footing toward the restructuring of the financial system is a prerequisite.

Based on the factors that I have explained so far, the world economy is expected to start recovering due to the effects of macroeconomic policies and financial system measures adopted by governments and central banks around the world and to the progress in adjustments of excesses in the private sector. However, the pace of recovery will likely be only moderate, and we also need to fully bear in mind the fact that there are high uncertainties regarding the scenario of the recovery itself.

II. The current state of and outlook for Japan's economy

Having explained the current situation of and outlook for the world economy, I will now move on to developments in Japan's economy.

The slowing of Japan's economic activity accelerated from around spring last year. And after the failure of Lehman Brothers last autumn, exports – particularly of automobiles, electrical machinery, and general machinery such as engineering and construction machinery – decreased sharply, and, as a result, production registered an unprecedented decline. The reason for Japan's economic downturn being sharp relative to other industrialized countries is that the manufacturing industries, especially high-tech ones, constitute a large part of economy activity in Japan and they tend to be influenced most by developments in the world economy. Recently, however, some brighter signs are beginning to appear in exports and production, reflecting the signs of recovery in the world economy, despite the continued deterioration in domestic economic conditions. Specifically, the pace of decline in exports slowed and has recently leveled out against the background of recovery in demand from China and progress in adjustments of overseas inventories such as automobiles and electronic goods. Production also showed a monthly increase in March, due partly to the progress in adjustments of inventories at home and abroad including automobiles and IT-related goods, after recording monthly declines of around 10 percent in January and February. In addition, information provided at interviews with the management of firms indicates that production will likely continue to increase going forward. We therefore judge that exports and production are beginning to level out. On the other hand, domestic private demand, such as consumption and business fixed investment, is likely to continue to weaken, given that the situation in household income and firms' profits, which hold the key in determining the future outlook for domestic private demand, is being adversely affected with a lag by a significant decline in production and will remain severe for the time being.

Based on the above assessment, the pace of deterioration in economic conditions is likely to moderate gradually, leading to a leveling out of the economy taken as a whole, given that exports and production are expected to level out and start recovering and the effects of the fiscal stimulus are likely to appear. Further ahead, from the latter half of fiscal 2009 onward, assuming that the world economy will show a mild recovery, as I mentioned earlier, the most likely outlook projects that Japan's economy will start recovering, supported partly by the positive effects of measures to stabilize the financial system and of fiscal and monetary policy measures.

Meanwhile, on the price front, the year-on-year rate of increase in the consumer price index (CPI) for all items excluding fresh food rose to 2.4 percent last summer due mainly to the rise in crude oil prices, but declined thereafter to around 0 percent reflecting the decline in prices of petroleum products and the stabilization of food prices. Looking ahead, the year-on-year rate of decline in the CPI (excluding fresh food) will likely accelerate through the middle of this fiscal year reflecting the deterioration in demand conditions in addition to the fact that the level of CPI at this time last year was elevated due mainly to the rise in prices of petroleum products and food. Thereafter, however, assuming that medium- to long-term inflation expectations remain stable, the rate of decline in the CPI (excluding fresh food) is likely to moderate as the effects of the changes in the prices of petroleum products abate.

The above projections regarding future economic activity and prices continue to be attended by considerable uncertainties. Those that demand attention are the downside risks. The Bank will continue to carefully monitor developments in economic activity and prices bearing in mind these downside risks.

III. Financial conditions

Developments in the world economy and in global financial markets are the major downside risks to Japan's economy, but I have already elaborated on them and I will now turn to Japan's financial conditions.

From last autumn, the effects of the financial crises in the United States and Europe spread to financial markets in Japan. In the money market, tensions increased as can be observed in wider spreads between interbank funding rates and short-term government security rates. The issuing conditions for CP and corporate bonds sharply deteriorated.

The initial cause of the recent tightening in financial conditions was the global credit contraction. Therefore, the recent changes in financial conditions are characterized by the sharper deterioration in financial positions of large firms than in those of small firms. The heightened pressures in the global financial and capital markets directly affected the financial positions of large firms through increased difficulty in raising funds from foreign banks and from the domestic CP and corporate bond markets. Large firms increased the volume of borrowing from banks and tried to hold ample liquidity at hand due to increased concerns over future financial conditions. The deterioration in financial positions of large firms negatively influenced the financial positions of small firms through various channels.

In view of these assessments, the Bank took aggressive policy actions in order to provide abundant liquidity in the money market and to facilitate corporate financing. These actions include the outright purchases of CP and corporate bonds. Although CP and corporate bonds are fund-raising tools used mainly by large firms, the revival of the functioning of these markets is expected to gradually affect the financial positions of small firms through improvements in banks' lending capability and in conditions for the provision of trade credit by large firms. In fact, as a result of the provision of ample liquidity by the Bank, the money market has gradually regained stability and the term interest rates, which are used as the reference rate when firms actually raise funds, declined. With further assistance from the Bank such as the outright purchases of CP, the issuing conditions for CP have been improving. As a result of the failure of Lehman Brothers last autumn, market perceptions of firms became increasingly severe, and firms were unable to issue CP unless it was offered with large new issue spreads added on to the short-term government security rates. However, the issuing conditions for CP started improving since around the end of last year when the authorities, including the Bank of Japan, took several actions, and recently, the new issue spreads for CP with high credit ratings have come down to the level prior to the failure of Lehman Brothers. In the case of CP with lower credit ratings, the new issue spreads have also been declining steadily. In addition, most recently, the new issue spreads of corporate bonds have declined somewhat. Looking at the track record of corporate bonds issued, while only some of the highest rated bonds could be issued during the period from last autumn through the end of last fiscal year, bonds with lower ratings have been issued recently, indicating a substantial improvement in the issuing conditions.

Since the issuing conditions for CP and corporate bonds have improved steadily and firms' demand to hold ample liquidity has declined, the severity in the financial positions of large firms has subsided. In addition, policy actions such as the emergency guarantee scheme have played a role in supporting the financial positions of small firms.

Thus, the tension in the environment surrounding corporate financing has eased relative to some time ago. However, we judge that conditions continue to be severe on the whole given that a large number of firms are reporting that their financial positions are weak and lending attitudes of financial institutions are severe against the backdrop of deterioration in corporate profits. Going forward, given the continued severe conditions surrounding corporate profits, there is a risk that, depending on future economic conditions, financial institutions and market participants may become stricter with regard to taking on corporate credit risks. Furthermore, we think it necessary to keep in mind the possibility of banks becoming strongly conscious of capital constraints and tightening their lending attitudes if stock prices should decline substantially. Therefore, it is necessary to continue to carefully monitor developments in corporate financing.

IV. Conduct of monetary policy

I have so far explained financial and economic conditions here and abroad. Confronted with the drastic changes in economic and financial conditions, countries around the world have taken policy actions aggressively since last autumn. Central banks have also taken a variety of policy measures. Reflecting the nature of the current economic crisis, where the world economy faced a simultaneous and sharp downturn, policy responses of central banks including the Bank of Japan have become quite similar. These can be broadly categorized in three main areas.

First is the reduction in the policy interest rate. As you know, the Bank of Japan has reduced its policy interest rate down to 0.1 percent, and central banks in other major countries have also substantially reduced their policy interest rates. As a result, interest rates charged for overnight funds in the interbank market now stand at 0.1 percent in Japan, 0.2 percent in the United States, 0.25 percent in Canada, and around 0.5 percent in the euro area and the United Kingdom. However, while major overseas countries have also reduced the level of interest rates down to nearly zero, they are, at the same time, aware of the side effects that extremely low interest rates may have on the functioning of money markets and the business conditions of financial institutions. They, therefore, have not adopted the zero interest rate policy which the Bank had adopted in the past where the policy interest rate was brought down literally to within a hairbreadth of 0 percent.

Second is ensuring financial market stability through the provision of abundant liquidity. Central banks have been providing abundant liquidity in their currency, while adopting measures such as lengthening the terms of funds provided. Furthermore, in the current financial crisis, central banks in major countries are providing dollar liquidity in coordination with the Federal Reserve, and this measure seems to be making substantial contributions in stabilizing financial markets.

Third is restoring the proper functioning of financial intermediation. In this regard, despite their common aims, they differ in terms of where the priority is attached reflecting the differences in the structure of financial intermediation in each country. At the end of 2007, the ratio of bank lending relative to nominal GDP, which can be used as a guide to capture the differences in the structure of financial intermediation, was 63 percent in the United States, 145 percent in the euro area, and 136 percent in Japan. On the other hand, the ratio of outstanding bonds issued by the private sector relative to nominal GDP was 168 percent in the United States, 81 percent in the euro area, and 94 percent in Japan. As these figures show, the role of financial intermediation in the United States is carried out mainly by the capital markets, whereas in the euro area it is bank lending. Japan comes in between the United States and the euro area, but the share of bank lending is relatively high. Reflecting these differences in the structure of financial intermediation, the Federal Reserve has been conducting large-scale purchases of assets such as CP and real estate mortgage-backed securities (RMBS) directly in the markets to restore the functioning of capital markets. The Federal Reserve calls it a "credit easing policy." On the other hand, the European Central

Bank (ECB) has introduced measures to restore the financial intermediation function of banks. Specifically, the ECB has expanded the range of eligible collateral that banks can submit in order to acquire funds from the central bank, and has been providing banks with unlimited amount of longer funds up to the value of eligible collateral at a fixed interest rate. Meanwhile, the Bank of Japan has been taking actions to both restore the functioning of the markets and strengthen the financial intermediation function of banks. In the area of restoring the functioning of capital markets, the Bank has been conducting outright purchases of CP and corporate bonds through banks, although the scale of purchases is small relative to the United States where the degree of impairment of market functioning has been substantial. In addition, in the area of strengthening the financial intermediation function of banks, the Bank, similar to the ECB, has been expanding the range of eligible collateral, and has also been providing long-term funds at low interest rates against corporate debt submitted as collateral. Through these measures, the Bank is aiming to facilitate smooth extension of bank credit.

In addition to the measures in three main areas, the Bank has prepared facilities such as purchases of stocks held by banks and provision of subordinate loans to banks. These facilities are designed to serve as safety valves for the proper functioning of financial intermediation by alleviating concerns over raising capital even in stress conditions where individual banks become strongly conscious of capital constraints due to concerns over a fall in stock prices. The purchases of CP and corporate bonds also have the function as safety valves when corporate financing becomes tight. As I mentioned earlier, there are various risks facing corporate financing, and a risk of another decline in the functioning of the CP and bond markets cannot be ruled out. In the event, financial institutions that hold CP and corporate bonds can submit them to the Bank for funding. Thus the purchases are designed to serve as a safety net to restore the market functioning if the CP and corporate bond markets should become unstable.

These are the policy measures that the Bank has taken and the thinking behind their introduction. The Bank, paying attention for the time being to the downside risks to economic activity and prices, will continue to exert its utmost efforts as the central bank, utilizing these tools, to facilitate the return of Japan's economy to a sustainable growth path with price stability.

Closing remarks

I have discussed the current financial and economic conditions in Japan and abroad as well as the outlook, and our thinking regarding the conduct of monetary policy. If I may summarize what I have explained earlier, the sharp deterioration in economic and financial conditions in Japan and abroad since last autumn is starting to level out and there is a prospect of a mild recovery ahead. However, considering the fact that the current economic downturn has occurred during the process of the adjustment of various excesses that had accumulated worldwide over the past several years, it is very likely that the severe economic conditions will continue for some time, and the recovery thereafter will inevitably be mild and attended by high uncertainty. Under these circumstances, policymakers around the globe, including the Bank, have been taking a variety of actions. These actions are playing an important role in temporarily mitigating the negative effects of economic and financial shocks and preventing the economy from sinking even further. The future path of the economy after recovering from the shocks will reflect the true strength inherent in the economy, that is, the potential growth rate. The major factor determining the potential growth rate is growth in productivity. Japan's economy cannot be expected to prosper without improving its productivity through innovation. Fiscal and monetary policies are important, but they merely assume a supporting role in facilitating adjustments of excesses and proactive efforts by the private sector.

Needless to say, making the most of the market mechanism is a prerequisite in order to realize innovation. Nevertheless, distrust in the market mechanism seems to be increasing, due to the emergence of the global financial crisis and to the fact that excess financial activity was one of the major factors behind the crisis. In the area of financial activity, appropriate regulation and supervision are prerequisites for the financial markets and financial institutions to properly fulfill their role of financial intermediation. I will not go into details on this point because I have already expressed my opinion in my speech the other day.[1] Active discussions to redesign the frameworks for regulation and supervision have been held worldwide, and the Bank has been taking part in many of such discussions. Through the experience of the current financial crisis, I am deeply recognizing the importance of the designing of the financial architecture that enables the market mechanism to function appropriately as well as the significance of the implementation of economic policies based on the market mechanism.

No one can predict exactly how the world economy will evolve after the current turmoil has ceased. Needless to say, however, Japanese firms need to continue to strive to find new frontiers, adapting to the changes in the global economy while making the most of their advantages.

Only through these efforts can a full-fledged recovery in Japan's economy be attained. The Bank would like to strongly support these efforts from the financial side to facilitate the autonomous recovery of Japan's economy.

Thank you very much for your attention.

[1] See Shirakawa, Masaaki, "Preventing the Next Crisis: The Nexus between Financial Markets, Financial Institutions and Central Banks," May 13, 2009.